from the total sales proceeds, is the amount properly includible in gross income; if it is understated, for whatever reason, by more than 25% of the amount of gross income stated in the return, Section 275 (c) is plainly applicable.

Nor is there any warrant in the legislative history for a contrary construction of the statute. The pertinent committee reports are focused upon gross income, and make it clear that understatements thereof, however occasioned, and whether due to negligence or to an honest mistake of law, are within the purview of the statute.

Moreover, for many years the courts unanimously applied this construction of the statute. Between 1941 and 1953 the Courts of Appeals for the Second, Fifth, Sixth and Ninth Circuits and the Tax Court consistently interpreted and applied the statute as relating to Section 22 (a) gross income. However, in 1953 the Third Circuit departed from this settled line of authority, holding in substance that omission from gross income within the meaning of Section 275 (c) means failure to report gross receipts. Since then the Fifth and Ninth Circuits have espoused the latter view, and the Eighth Circuit and Court of Claims have also taken this position, with various modifications.

The Sixth Circuit and the Tax Court, however, have continued to adhere to the view that the statute applies to Section 22 (a) gross income, which is also the view of the Second Circuit as reflected in its single decision on the subject. The Government believes that this is the correct interpretation, and, indeed, the

only interpretation consistent with the plain language of the statute and its legislative history. Hence the understatements of gross income in this case are within the purview of Section 275 (c), and the Commissioner's notices of deficiency were timely under the applicable five-year period of limitations.

ARGUMENT

THE COURTS BELOW CORRECTLY HELD THAT THE FIVE-YEAR STATUTE OF LIMITATIONS WITH RESPECT TO DEFICIENCY ASSESSMENTS WAS APPLICABLE BECAUSE TAXPAYER UNDERSTATED BY MORE THAN 25 PERCENT THE AMOUNT REPORTED AS GROSS INCOME IN ITS RETURNS

A. PRELIMINARY

The single issue in this case concerns the applicability of the five-year statute of limitations with respect to deficiency assessments provided in Section 275 (c) of the Internal Revenue Code of 1939, *supra*, pp. 3–4. In enacting Section 275 (c), Congress was dealing exclusively with civil tax liability. Moreover, when this section was enacted, as we shall demonstrate *infra*, pp. 18–20, provision had already been made in the revenue laws for an unlimited period within which to assess civil tax liabilities, both where taxpayers had wilfully filed false returns and where taxpayers, wilfully or unwilfully, had filed no returns. In all other cases, the Commissioner had three years from the filing of a return within which to assess deficiencies, regardless of the nature or extent of the errors in the return. Weighing against the desirability of an early termination of disputes the desirability of having each taxpayer bear his proportionate share of the

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In the Supreme Court of the United States

OCTOBER TERM, 1957

THE COLONY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
JOSEPH F. GOETTEN,
GRANT W. WIPRUD,
Attorneys,
Department of Justice, Washington 25, D. C.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3–26) are reported at 26 T. C. 30. The opinion of the Court of Appeals (R. 42–43) is reported at 244 F. 2d 75.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1957. (R. 42.) The petition for a writ of certiorari was filed on July 22, 1957, and was granted on October 14, 1957. (R. 43.) The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTION PRESENTED

In determining whether the Commissioner is entitled to the benefit of the five-year statute of limita-

tions with respect to deficiency assessments provided in Section 275 (c) of the Internal Revenue Code of 1939, the question is:

Where gain from the sale of property is understated by more than 25% of the amount reported as gross income in the return, does such understatement of gain constitute an omission "from gross income [of] an amount properly includible therein," notwithstanding that it results from subtracting an excessive cost basis rather than from understating the total proceeds of sale?

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property

shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(26 U. S. C. 1952 ed., Sec. 111.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a) adjusted as hereinafter provided.

* * * * *

(26 U. S. C. 1952 ed., Sec. 113.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess

of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 275.)

SEC. 276. SAME—EXCEPTIONS.

(a) *False Return or No Return.*—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

* * * * *

(26 U. S. C. 1952 ed., Sec. 276.)

STATEMENT

The material facts, as found by the Tax Court (R. 3, 7–15) and as reflected in taxpayer's returns for the years in question (R. 27–41), may be summarized as follows:

Taxpayer is a Kentucky corporation organized in 1945. Shortly after incorporation, taxpayer acquired a farm of approximately 228 acres near Lexington, Kentucky, for the purpose of subdivision into residential lots. Taxpayer's principal business thereafter was the development and sale of such lots to individual buyers. It sold some of these lots in each of its fiscal years ended October 31, 1946, 1947 and 1950. (R. 3, 7–8.)

An account entitled "Reserve for Improvements" was set up on taxpayer's books and credited on Sep-

tember 30, 1946, in the amount of $93,074.61. This amount represented taxpayer's estimate of the costs which would be incurred in the development of the subdivision. The reserve account was debited in the amount of each expenditure which taxpayer considered an expense of development for the subdivision. As of September 30, 1950, the total amount debited to the account was $87,483.79, leaving a credit balance of $5,590.82. The total amount debited to the reserve account consisted of the following entries: (1) $33,781.70, the cost of a water supply system; (2) $8,713.54, the total of payments to utility companies; and (3) $44,988.55 for other expenditures not here in issue. (R. 12.)

For the purpose of computing and reporting gain from the sale of the lots sold in 1946, 1947 and 1950, taxpayer included as part of the basis of the lots a proportionate part of $93,074.61, the amount originally estimated for development costs and credited to the reserve account. The total basis claimed by taxpayer for the subdivision, including the estimated development costs, was $131,550. (R. 8, 12.)

In its income and declared value excess-profits tax return for the fiscal year ended October 31, 1946, taxpayer reported "Total income" of $22,250.03. (R. 27.) Taxpayer arrived at this figure, as shown by schedule A submitted with that return (R. 32), in the following manner:

Sales of 29 lots "The Colony Subdivision"	$78,987.50	
Less Cost of Lots Sold	57,375.00	
Profit on Lot Sales		21,612.50
Sales of Farm Products		637.53
Total Gross Revenue		$22,250.03

In its income tax return for the fiscal year ended October 31, 1947, taxpayer reported "Total income" of $18,095.41. (R. 36.) Taxpayer arrived at this figure, as revealed by Schedule A submitted with the return (R. 38), in the following manner:

Gross Profit—Farm		$8,595.41
Sales of 9 Lots	$28,075.00	
Less Cost of Lots Sold	18,575.00	
Gross Profits—Lots		9,500.00
Total Gross Revenue		18,095.41

On audit of these returns (and the subsequent return for the year ended October 31, 1950) the Commissioner determined that the total amount of development costs includible in the basis of the lots did not exceed $44,988.55, and therefore that the total basis of the subdivision did not exceed $83,463.94. The Commissioner reached this determination by disallowing the following items of claimed development expense: (1) That portion of the original estimated cost of development which taxpayer had not expended as of September 30, 1950 ($5,590.82); (2) taxpayer's expenditures to acquire a water supply system ($33,781.70); and (3) taxpayer's payments to the utility companies ($8,713.54). (R. 8.) The total over-statement of basis thus determined by the Commissioner was allocated to the lots sold each year in the further determination of deficiencies for the fiscal years ended October 31, 1946, 1947 and 1950. (R. 12–14).

The deficiency notices for the tax years ended October 31, 1946, and 1947, were mailed within the ex-

tended periods provided in waivers which taxpayer executed more than three years but less than five years after the returns were filed. (R. 15.)

The Tax Court agreed with the Commissioner in disallowing as items of development cost the cost of the water supply system and the credit balance of the estimated development cost, but found that the amounts paid to utility companies were properly includible in basis. (R. 19–25.)[1] Having thus disallowed $39,372.52 of the claimed development cost, the Tax Court found that the total basis of the subdivision did not exceed $92,177.48, or 70.07% of the basis claimed. More particularly, the Tax Court found that the basis of the lots sold in the year ended October 31, 1946, was $40,202.66 (rather than $57,375 as reported by taxpayer), and in the year ended October 31, 1947, was $13,015.50 (rather than $18,575 as reported by taxpayer). As a necessary corollary to these overstatements of basis, the Tax Court further found that taxpayer had understated its gross income for the year ended October 31, 1946, by $17,172.34 (77.2% of the amount reported as gross income), and had understated its gross income for the year ended October 31, 1947, by $5,559.50 (30.7% of the amount reported as gross income). (R. 14–15.)

The Tax Court found as an ultimate fact that, in its returns for each of the years ended October 31, 1946, and October 31, 1947, taxpayer omitted from

[1] Since taxpayer does not dispute the Tax Court's disallowance of claimed items of development cost, it is unnecessary to summarize the Tax Court's detailed findings (R. 8–11) with respect to those items.

gross income an amount properly includible therein which was in excess of 25% of the amount of gross income stated in the returns. (R. 15.)

On the basis of these findings, the Tax Court held that the 5-year period of limitations in Section 275 (c) is applicable, and that the deficiencies for the years 1946 and 1947 were therefore not barred by the statute of limitations. (R. 26.) The Court of Appeals affirmed in a *per curiam* opinion. (R. 42–43.)

SUMMARY OF ARGUMENT

Congress enacted Section 275 (c) of the Internal Revenue Code of 1939 to provide a longer period for assessing deficiencies where errors in returns adversely affecting the revenue were relatively large. It described the type of error with which it was concerned as an omission from "gross income [of] an amount properly includible therein," and provided for measurement of such errors in terms of a percentage of the amount of "gross income stated in the return." The interrelationship of the error description and standard of measurement provisions makes it clear that Congress meant that a failure to state an amount as gross income anywhere in the return would constitute an omission of that amount from gross income. In enacting Section 275 (c), Congress was as concerned with honest errors as it was with dishonest errors; for purposes of that section, if an amount is omitted from gross income which is properly includible therein, it is immaterial that the amount may be disclosed elsewhere in the return in

some form other than as gross income, as, for example, a return of capital invested.

It is undisputed here that taxpayer understated the amount reported as gross income for the tax years involved by more than 25%, owing to an overstatement of the basis of realty sold during those years. The Commissioner's notices of deficiency were mailed within the extended period provided in waivers which taxpayer executed more than three years, but less than five years, after the returns were filed. The narrow question presented here is whether taxpayer's understatements of gain from sales constituted omissions from gross income within the meaning of Section 275 (c) of the 1939 Code, which provides a five-year period of limitations for the assessment and collection of deficiencies.

We submit that the terms of Section 275 (c) are clear and unambiguous, and apply precisely to the case at bar. They provide for a five-year period of limitations where there is omitted from gross income an amount properly includible therein exceeding 25% of the amount of gross income stated in the return. Amounts properly includible in gross income must be determined by reference to Section 22 (a), which defines gross income for the purposes of the income tax laws, and specifically enumerates gains from sales as properly includible items. Under Section 111 (a) the gain from the sale of property is the excess of the amount realized therefrom (total sales proceeds) over the adjusted basis (essentially cost, see Section 113, *supra*, p. 3) of the property. Hence, the amount of gain from the sale of property, as distinguished

tax burden, Congress in enacting Section 275 (c) decided to provide for a longer period for assessing deficiencies where errors in returns adversely affecting the revenue were relatively large. If a taxpayer reported an income of $99,000 when he should have reported $100,000, the error of $1,000 might be relatively small. If another taxpayer reported an income of $4,000 when he should have reported $5,000, the error, although in the same amount, would be relatively large. Accordingly, if the longer period of limitations was to apply exclusively to relatively large errors it was necessary to measure the error in relation to the amount of income reported. Congress undoubtedly could have chosen to express the error in terms of an omission from "net income" and to have measured the error in terms of a percentage of the "net income" reported. This, however, for whatever reason,[2] it did not do. Congress rather chose to express the error in terms of an omission from "gross income of an amount properly includible therein," and to measure the error in terms of a percentage "of the amount of gross income stated in the return."

In the light of this general background, we would at the outset emphasize two observations before proceeding to a detailed consideration of the statutory language and its construction. First, Congress was primarily concerned with the relative size of the error in the return adversely affecting the revenue,

[2] To attempt, in the absence of any reliable indication in the legislative history, to ascribe to Congress a reason for not using the term "net income"—or, for that matter, to have addressed itself to understatements of the tax itself—in Section 275 (c) would be pure speculation.

and there is, accordingly, an essential correlation between its description of that error and its expression of the standard for measuring it. The standard is expressed in terms of a percentage of the amount of gross income stated in the return. Since the return contains no single item entitled "gross income," the amount of gross income stated in the return must necessarily be the sum of the items stated in the various parts of the return as gross income. It would seem logically to follow that a taxpayer has omitted from gross income an amount properly includible therein when he has understated that amount, or failed to state it at all as gross income in any of the various parts of the return. Secondly, in enacting Section 275 (c) Congress was concerned with results, not causes; with relatively large mistakes, not whether they were honest or dishonest; and, for example, with whether the amount of a dividend was reflected in a return as gross income, not whether or not it may have been disclosed but erroneously shown as affecting only the stock's basis because it was paid out of capital. It would also seem to follow, therefore, in the absence of any indication to the contrary, that in enacting this legislation Congress intended to cover the situation where a taxpayer failed to state an amount of gain from the sale of property as gross income anywhere in his return, regardless of whether he disclosed the amount but erroneously showed it as a return of his capital investment in the property.

In its tax returns for the years ended October 31, 1946, and October 31, 1947, taxpayer reported as part of its gross income certain gains from the sale of real

estate. The Tax Court found that taxpayer had substantially overstated the basis of the realty in computing the gains from sales, and hence had understated both the gains and the total gross income reported by more than 25%. Further, the Tax Court rejected the taxpayer's contention that assessment and collection of deficiencies were barred by the statute of limitations, holding that the Commissioner's deficiency notices were timely under the five-year period of limitations provided by Section 275 (c) of the 1939 Code.

In this Court, as in the Court of Appeals, taxpayer does not dispute the Tax Court's finding that the amount taxpayer reported as gross income for the years in question was understated by more than 25%. Nor does taxpayer deny that the Commissioner's deficiency notices were timely if Section 275 (c) is applicable. But taxpayer renews here its contention that Section 275 (c) is inapplicable; that the general three-year period of limitations provided by Section 275 (a), *supra*, p. 3, is controlling; and therefore that collection of the deficiencies is barred, the deficiency notices having been mailed within the extended period provided in waivers executed by the taxpayer more than three years after the returns were filed.

The narrow question,[3] then, is whether Section 275 (c) applies to an understatement of gross income by more than 25%, resulting from an overstatement of

[3] This question should be considered in the light of the statement in *Dupont de Nemours & Co.* v. *Davis*, 264 U. S. 456, 462: "Statutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government."

basis and corresponding understatement of gains from sales of realty. As we shall now demonstrate, the plain language of the statute, its legislative history, and the more soundly-reasoned line of judicial decisions compel an affirmative answer to this question.

B. THE STATUTE AND ITS LEGISLATIVE HISTORY

Section 275 (c) provides in pertinent part:

> If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, * * * at any time within 5 years after the return was filed.

There is obviously nothing in the statute to indicate that the term "gross income" is used in any special or limited sense. It is appropriate, then, to refer to the general definition of "gross income" for purposes of the income tax laws, as set forth in Section 22 (a) of the 1939 Code, *supra*, p. 2. That definition embraces, *inter alia*, "*gains * * * derived from * * * sales * * **." (Italics supplied.) In turn, "gain from the sale" of property is defined by Section 111 (a) of the 1939 Code, *supra*, pp. 2–3, as the excess of the amount realized from the sale (total sales proceeds) over the adjusted basis (essentially cost) of the property as determined under Section 113. Thus it is clear that the total sales of property do not constitute "gross income" for purposes of the income tax laws. It is only the excess of such proceeds over the cost basis which constitutes "gain from the sale" under Section 111 (a), and which as such is therefore prop-

erly includible in "gross income" as defined by Section 22 (a).

Section 275 (c) by its terms applies to an omission from "gross income" of "an amount properly includible therein." Total proceeds of sales are not properly includible; gains from sales are. It follows that where a taxpayer includes gains from sales in reported gross income, and such gains are understated, the taxpayer "omits from gross income an amount properly includible therein," i. e., the amount of the understatement. It is immaterial whether the understatement is occasioned by an understatement of total sales proceeds or an overstatement of cost basis.

This conclusion is confirmed by other language in Section 275 (c). The term "gross income" is used twice in that section, first in the opening phrase with respect to omissions of amounts properly includible, discussed above, and second, in the ensuing phrase which provides that the omissions must exceed 25% "of the amount of gross income stated in the return * * *." Here again the orthodox concept of gross income set forth in Section 22 (a) is surely applicable. The return form does not call for a single figure entitled "gross income"; it rather includes, for the various types of income enumerated in Section 22 (a), separate schedules in each of which an amount is stated as gross income of a particular type. It is the sum of these amounts stated as gross income of various types that constitutes "the amount of gross income stated in the return." Amounts of income shown in the various schedules are carried forward

as "Total income" on the face of the return. Thus, taxpayer's return for its fiscal year ended October 31, 1946, shows on its face a total income figure of $22,250.03—and, indeed, shows no other figure, reference being made to an attached schedule for the computation. (R. 27.) When the schedule (R. 32) is consulted, it reveals that the figure of $22,250.03, carried to the face of the return, is stated in the schedule as "Total Gross Revenue," and insofar as the sales of lots are concerned, quite properly includes only the gain from such sales as distinguished from the total sales proceeds. To deny that this figure stated as total gross revenue is the "gross income stated in the return" is to deny the clear meaning of that language and the obvious intent of Congress.

It is questionable, moreover, whether taxpayer does deny this. As noted above, taxpayer does not challenge the Tax Court's finding that its gross income for the years involved was understated by more than 25%. That finding relates to an understatement of the amounts stated as total gross revenue in taxpayer's returns, and in accepting the finding taxpayer is clearly accepting the ordinary and usual meaning of the language, "gross income stated in the return * * *." Yet taxpayer contends that the term "gross income" has quite another meaning in the opening phrase of Section 275 (c), i. e., "omits from gross income an amount properly includible therein * * *." As used in that phrase, taxpayer contends, in substance, the term "gross income" means "gross receipts reported somewhere in the return," even though such gross

receipts are not "properly includible in gross income." We submit that the clear and unambiguous language of the statute affords no basis whatever for such an interpretation but, rather, compels the conclusion that Congress intended to deal with omissions from "gross income" in the usual and accepted sense of that term, as defined by Section 22 (a). Hence any understatement of "gain" from the sales of property—whether it results from an understatement of gross proceeds or an overstatement of basis—necessarily results in an omission from "gross income" within the meaning of Section 275 (c).

This is the plain meaning of the statute, and the pertinent committee reports hardly suggest—much less compel—a contrary construction. The provisions of Subsection (c) of Section 275 first appeared in Section 275 (c) of the Revenue Act of 1934, c. 277, 48 Stat. 680. The bill originating in the House would have amended Section 276 of the Revenue Act of 1932, c. 209, 47 Stat. 169, relating to no returns or fraudulent returns, and would have made inapplicable any statute of limitations on assessments where taxpayers understated their gross income by a large amount. The reason for the provisions was stated in a subcommittee report published as part of the House Hearings on the Revenue Revision of 1934, p. 139, as follows:

> Section 276 provides for the assessment of the tax without regard to the statute of limitation in case of a failure to file a return or in case of a false or fraudulent return with intent to evade tax.

> Your subcommittee is of the opinion that the limitation period on assessments should also not apply to certain cases where the taxpayer *has understated his gross income* on his return by a large amount, even though fraud with intent to evade tax cannot be established. It is, therefore, recommended that the statute of limitations shall not apply where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return. The Government should not be penalized when a taxpayer is so negligent as to leave out items of such magnitude from his return. [Italics supplied.]

The full Committee adopted this reasoning as part of its report, published in H. Rep. No. 704, 73d Cong., 2d Sess., p. 35 (1939–1 Cum. Bull. (Part 2) 554, 580), as follows:

> Section 276 (a). No return or false return: The present law permits the Government to assess the tax without regard to the statute of limitations in case of failure to file a return or in case of a fraudulent return. The change in this section continues this policy, but enlarges the scope of this provision to include cases wherein the taxpayer *understates gross income* on his return by an amount which is in excess of 25 percent of the gross income stated in the return. It is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute. [Italics supplied.]

The Finance Committee of the Senate incorporated this language in Section 275, except that it provided for a five-year period of limitations. It was this provision that was finally enacted into law. In its report (S. Rep. No. 558, 73d Cong., 2d Sess., pp. 43–44 (1939–1 Cum. Bull. (Part 2) 586, 619)) the Committee said:

> The present law permits the Government to assess the tax without regard to the statute of limitations in case of failure to file a return or in case of a fraudulent return. The House bill continues this policy, but enlarges the scope of of this provision to include cases wherein the taxpayer *understates gross income* on his return by an amount which is in excess of 25 percent of the gross income stated in the return. Your committee is in general accord with the policy expressed in this section of the House bill. However, it is believed that in the case of a taxpayer who makes an *honest mistake,* it would be unfair to keep the statute open indefinitely. *For instance, a case might arise where a taxpayer failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital* or he might report as income for one year an item of income which properly belonged in another year. Accordingly, your committee has provided for a 5-year statute in such cases. * * * [Italics supplied.]

It is clear from the above reports, as it is from the plain language of the statute, that the Congressional intent was to fix a longer period of limitations where gross income is understated by more than 25% of the

amount actually stated in the return. Taxpayer attempts to minimize the explicit references to understatement of gross income which we have italicized above, by contending (Br. 16): "Immediately following each such reference is a specific restrictive statement or illustration of a 'failure to disclose' income or 'leaving out' items of receipt." What taxpayer fails to point out, however, is that the specific statements or illustrations also allude only to gross income, not receipts. Let us examine the allegedly "restrictive" statements or illustrations in the committee reports, particularly those with respect to "failure to disclose" or "leaving out." The House subcommittee report, first quoted above, speaks of situations "where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return." The full committee report of the House, quoted above, speaks of situations "wherein the taxpayer understates gross income on his return by an amount which is in excess of 25 percent of the gross income stated in the return." Taxpayer does not quote that part of the committee report, but only the ensuing sentence (Br. 16), "It is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute." Obviously, in view of the preceding sentence, the full committee was speaking of taxpayers who "leave out" of their returns "items" of gross income. Finally, there is the Senate report, quoted above, which again speaks of "cases wherein the taxpayer understates gross income on his return

by an amount which is in excess of 25 percent of the gross income stated in the return." This report goes on to state that the new provision is intended to cover "an honest mistake," and gives as examples cases where "a taxpayer failed to report a dividend" because of erroneous advice that it was a return of capital, or where "he might report as income for one year an item of income which properly belonged in another year.[4]

The reports thus make it evident that Congress was concerned with omissions from "gross income" exceeding 25% of the "gross income stated in the return," and that understatements of gross income constituted such omissions in the view of the committees. There is not one reference to a "failure to disclose" or a "leaving out" of items of gross proceeds or gross receipts. There are only references, as demonstrated above, to a failure to disclose gross income; to a leaving out of items of gross income; and, finally, to a failure to report a dividend, which is obviously part of a distributee's gross income if it is not a return of capital.

Taxpayer relies (Br. 15) on a colloquy between Congressman Jere Cooper and a Treasury official. We submit, however, that Congressman Cooper's informal remarks need not be interpreted in a manner contrary to the plain language of the statute and

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[4] Since it is immaterial whether or not the omission results from an honest mistake, it cannot avail taxpayer to insist (Br. 10) that it overstated the basis of the property sold "in good faith, but erroneously," and that "*there is no suggestion of fraud, negligence or lack of good faith* in this case." [Taxpayer's italics.]

of the committee reports. Indeed, he too speaks of taxpayers who omit items exceeding 25% of gross income. Moreover, even if the quoted remarks plainly indicated another view, they would certainly have to yield to the provisions of the statute and the explicit views of the full committees.

This brings us to taxpayer's contention (Br. 23–24) that, in enacting Section 6501 (e)(1)(A) of the 1954 Code as the successor provision to Section 275 (c) of the 1939 Code, Congress intended only to clarify existing law. Curiously enough, however, taxpayer does not ground this contention upon the legislative history of the 1954 Code, but upon views expressed by the Fifth Circuit in *Davis* v. *Hightower*, 230 F. 2d 549. Surely Congress itself is the best authority for its own intentions and views, as reflected in the relevant committee reports, which, in substantially identical language, explicitly state as follows (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A414 (3 U. S. C. Cong. & Adm. News (1954) 4017, 4561); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 584 (3 U. S. C. Cong. & Adm. News (1954) 4621, 5233)):

> *Several changes from existing law* have been made in subsection (e) of this section. In paragraph (1), which relates to income tax, the existing 5-year rule in the case of an omission of 25 percent of gross income has been extended to 6 years. The term *gross income* as used in this paragraph has been *redefined* to mean the total receipts from the sale of goods or services prior to diminution by the cost of such sales or services. A *further change from existing law* is the provision which states that any amount

> as to which adequate information is given on the return will not be taken into account in determining whether there has been an omission of 25 percent. [Italics supplied.]

Obviously, then, in enacting the 1954 Code, Congress understood that it was making changes in the existing law, and that it was redefining the term gross income to mean total receipts. This confirms, if any confirmation be necessary, that Congress used the term gross income in its orthodox sense in Section 275 (c) of the 1939 Code, and that it meant the statute to apply to all omissions from gross income, so understood, exceeding 25% of the gross income stated in the return. Hence it is clear that the courts below correctly held that Section 275 (c) was applicable to the case at bar.

C. THE DECIDED CASES

Section 275 (c) is applicable in terms to omissions from gross income of all amounts properly includible therein, where such amounts exceed 25% of the amount of gross income stated in a taxpayer's return. In these provisions, as has been demonstrated, the term gross income was obviously used in its usual sense, as defined by Section 22 (a); hence understatements of gross income constitute omissions therefrom, within the meaning of Section 275 (c), whether they result from failure to report items of receipt or, in the case of gains, from overstatements of basis.

The courts had unanimously adopted this view of the statute until a comparatively recent date. In 1941 it was held in *Maloy* v. *Commissioner*, 45 B. T. A.

1104, that the term gross income, as used in Section 275 (c), does not mean gross receipts, but amounts properly includible in gross income as defined by Section 22 (a), and hence that only 50% of certain long-term capital gains were includible in determining whether there had been an understatement of gross income exceeding 25%. The following year, in *Foster's Estate* v. *Commissioner*, 131 F. 2d 405 (C. A. 5th), the court expressly invoked (p. 406) the definition of gross income set forth in Section 22 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, which was the predecessor of Section 22 (a) of the 1939 Code, as the definition applicable to the term "gross income" appearing in the statutory predecessor of Section 275 (c). In 1944 the Second Circuit held in *Ketcham* v. *Commissioner*, 142 F. 2d 996, that Section 275 (c) is not averted by disclosure of gross receipts, since the question is whether there has been omission from gross income of amounts properly includible therein. The court said (p. 997):

> That she [the taxpayer] attached schedules to her returns, stating that she had received certain amounts as trust income in lieu of alimony but that such amount was taxable to her husband, cannot relieve her from the effect of having omitted those amounts from her report of gross income. *Foster's Estate* v. *Commissioner*, 5 Cir., 131 F. 2d 405.

In the same year the Sixth Circuit rendered two pertinent decisions. The first, *Ewald* v. *Commissioner*, 141 F. 2d 750, contained a detailed discussion of the legislative history of Section 275 (c), and

adopted the same construction of the statute. The court said (p. 753): "It is clear that it was the congressional purpose to fix a longer period of limitation regardless of the intention of the taxpayer where the sum omitted from gross income was 25 percent or more." The second decision, *Reis* v. *Commissioner*, 142 F. 2d 900, is squarely in point here, for it involved understatements of gain from sales—and hence of gross income—which resulted from overstatements of basis. The court held that such understatements constituted omissions from gross income within the meaning of Section 275 (c), saying (p. 903):

> The cost basis is fixed by statute. Sec. 111 (a) of the Revenue Acts of 1934 and 1936 * * * provides that the gain from the sale of property shall be the excess of the amount realized therefrom over the basis provided in Sec. 113, and Sec. 113 (a) provides that "the basis of property shall be the cost of such property." It is obvious that petitioner adopted an incorrect basis. * * *
>
> The Court allowed petitioner as a basis the $5,000 which he paid in cash for the property, certain items of taxes and indebtedness which he had assumed, and $35 representing the cost of a locomotive reel which he had purchased and sold in 1935. He added to these amounts an item of $6,463.57. These allowances, so far as they go, are uncontroverted and we find no reason for disturbing them. They aggregate $15,613.95 instead of $78,796.74, the basis allocated by petitioner against the sale of assets. When we ascribe to the word "omits" the meaning given to it in *Ewald* v. *Commissioner*, 6 Cir., 141 F.

> 2d 750, it follows that petitioner failed to include in his returns gross income properly includible in excess of 25% of the amount stated therein, and that the five year limitation period, Sec. 275 (c) of the Revenue Act of 1936, was not a bar.

Accord: *American Liberty Oil Co.* v. *Commissioner*, 1 T. C. 386; *American Foundation Co.* v. *Commissioner*, 2 T. C. 502.

In 1945 the Ninth Circuit decided *O'Bryan* v. *Commissioner*, 148 F. 2d 456. In that case the taxpayer, separated from his wife, prepared his return on the theory that his income was still community property and therefore taxable in equal shares to husband and wife. On the face of his return he stated the total amount of gross receipts from his business, and the expenses thereof, and then stated one-half of the receipts and one-half of the expenses as the figures upon which he computed his total gross income. He also indicated in his return that a separate return was being filed for his wife. The Ninth Circuit held, as had the Second Circuit in *Ketcham*, that the test under Section 275 (c) is whether there has been an omission from *gross income*—not whether there has been an omission of, or failure to include *gross receipts* somewhere in the return. The court said (pp. 459–460):

> The mere appearance of the total amount of gross income somewhere on the face of an income tax return is not sufficient to prevent an omission within the terms of § 275 (c). * * * It is apparent from the pertinent legislative history that care and good faith on the part of of a taxpayer will not prevent the applicability

of subsection (c). *Ewald* v. *Commissioner of Internal Revenue,* 6 Cir., 1944, 141 F. 2d 750, 753. To satisfy the terms of the section, the figure which represents gross income and from which net income is derived must not be understated by an amount in excess of 25 per cent of the figure. In the instant case gross income was shown as only half the correct amount. Therefore, the limitation period for assessing deficiencies was determined by § 275 (c). *Ketcham* v. *Commissioner of Internal Revenue,* 2 Cir., 1944, 142 F. 2d 996, 997; *Reis* v. *Commissioner of Internal Revenue,* 6 Cir., 1944, 142 F. 2d 900, 903; *Foster's Estate* v. *Commissioner of Internal Revenue,* 5 Cir., 1942, 131 F. 2d 405, 406.

Thus, by 1945, the Second, Fifth, Sixth, and Ninth Circuits and the Tax Court had held that an omission from gross income, within the meaning of Section 275 (c), does not mean an omission from a return of items of gross receipts, but an omission from gross income as defined by Section 22 (a). As aptly stated by the Ninth Circuit in the above-quoted language from *O'Bryan,* "the figure which represents gross income and from which net income is derived must not be understated by an amount in excess of 25 per cent of the figure." Hence, disclosure of gross receipts, whether in a schedule as in *Ketcham* or on the face of a return as in *O'Bryan,* was regarded as immaterial. And it necessarily followed, as held in *Reis,* that an understatement of gains from sales which results from an overstatement of basis is an omission from gross income within the meaning of the statute. See Rich-

ards, *The Extended Statute of Limitations on Assessment*, 12 Tax Law Review 297.

All appellate courts considering the question had adopted this view prior to 1945, and none took a contrary view for eight years thereafter. Indeed, the law seemed so well settled on this point that the Tax Court resorted to memorandum decisions in 1950 and 1951, in holding that understatements of gains from sales resulting from overstatements of basis were within the purview of Section 275 (c). *Owen-Fields Importing Co.* v. *Commissioner*, decided November 17, 1950 (1950 P-H T. C. Memorandum Decisions, par. 50,279); *Ohio Fruit Products Co.* v. *Commissioner*, decided January 31, 1951 (1951 P-H T. C. Memorandum Decisions, par. 51,040).

In 1953, despite this long-standing, consistent administrative practice and judicial construction, the Third Circuit, in *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570, held that understatements of gross income by a manufacturing corporation, owing to overstatements of the cost basis of goods sold, were not omissions from gross income within the meaning of Section 275 (c). The court reached this conclusion on the theory that omission from gross income, within the meaning of Section 275 (c), meant omission of some item of gross receipt from the computation of gross income. In adopting this theory, the court ignored the rationale of such previous decisions as *Ketcham* and *O'Bryan*, *supra*, preferring to dismiss those cases as factually distinguishable and hence not in point. *Reis* v. *Commissioner*, *supra*, which could not be factually distinguished, was not mentioned.

In substance, *Uptegrove Lumber Co.* stands for the proposition that omission from gross income, within the meaning of Section 275 (c), means nothing more than failure to report gross receipts. Under that construction the additional requirement, that gross receipts must enter into some stage of the computation of gross income, has little substance; a taxpayer need only report his gross receipts and immediately offset them with an overstated basis in order to avert the application of Section 275 (c), as interpreted by the Third Circuit. This construction ignores the definition of gross income set forth in Section 22 (a), and the fact that Section 275 (c) in clear terms applies to omissions from gross income of amounts properly includible therein exceeding 25% of the gross income stated in the return.

In the following year the line of authority from *Ketchum* to *Reis* was followed in *Carew* v. *Commissioner*, 215 F. 2d 58 (C. A. 6th). In that case the taxpayer had included in his statement of the cost of goods sold such improper items as an amount labelled alimony settlement, thereby overstating his cost basis and understating his gross profit. The taxpayer also omitted an item of capital gain from the return. It was held, with respect to the overstatement of the cost of goods sold, that there was an omission from gross income within the meaning of Section 275 (c), even though gross receipts were reported, and even though on the information given the Commissioner could have revised the return. In so ruling the court cited all of the decisions discussed above, quoting (p. 62) from *O'Bryan* the succinct statement that:

"To satisfy the terms of the section, the figure which represents gross income and from which net income is derived must not be understated by an amount in excess of 25 per cent of the figure." The Sixth Circuit dismissed the *Uptegrove Lumber Co.* decision as distinguishable upon its facts.

The Third Circuit, however, adhered to its position in *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894, stating that Section 275 (c) does not apply where the taxpayer (p. 897) "merely understates the final figure in this gross income computation, the item in question having been disclosed in the return but eliminated in the computation of the final figure." More recently, notwithstanding their earlier decisions, discussed above, the Fifth and Ninth Circuits have accepted this view; indeed, they have apparently gone further than the Third Circuit by requiring only that there be disclosure of gross receipts in the return, and failing to require that the gross receipts enter into the computation of gross income. *Davis* v. *Hightower*, 230 F. 2d 549 (C. A. 5th); *Slaff* v. *Commissioner*, 220 F. 2d 65 (C. A. 9th). The defects in this "disclosure" theory, as we see it, consist in (1) overlooking the fact that Section 275 (c) is aimed at honest mistakes as well as others, and (2) failing to recognize that the significance of disclosure for purposes of that section is disclosure of an amount as "gross income". Similar positions have been taken by the Eighth Circuit in *Goodenow* v. *Commissioner*, 238 F. 2d 20, and the Court of Claims in *Lazarus* v. *United States*, 142 F. Supp. 897. In sum, the Third Circuit's theory has now been adopted, with various

modifications, by three other circuits and the Court of Claims.

The Sixth Circuit, however, has adhered to the older line of authority, not only in *Carew* in 1954 but in the case at bar. The Tax Court has also consistently adhered to this position, in *Estate of Gibbs* v. *Commissioner*, 21 T. C. 443, decided in 1954, in *Goodenow* v. *Commissioner*, 25 T. C. 1, reversed, 238 F. 2d 20 (C. A. 8th), in the case at bar, and most recently, in *Lawrence* v. *Commissioner*, 27 T. C. 713, now pending on appeal in the Ninth Circuit. Moreover, the rationale of the Second Circuit in its *Ketcham* decision, discussed above, is fully in accord with the views of the Sixth Circuit and the Tax Court.

For the reasons given above, we submit that the correct interpretation and application of Section 275 (c) is found in the decisions of the Second and Sixth Circuits and the Tax Court, and in the earlier decisions of the Fifth and Ninth Circuits. In departing from this line of authority and holding, in effect, that the term gross income as used in Section 275 (c) means gross receipts, we submit that the *Uptegrove Lumber Co.* case is in direct conflict with the clear language of the statute and the legislative history. That "gross income" does not embrace the cost of goods sold, even though that cost includes an excess over the prices fixed by O. P. A., is well settled. *Sullenger* v. *Commissioner*, 11 T. C. 1076, appeal dismissed June 6, 1949 (C. A. 5th); *Commissioner* v. *Weisman*, 197 F. 2d 221 (C. A. 1st); *Hofferbert* v. *Anderson Oldsmobile, Inc.*, 197 F. 2d 504 (C. A. 4th); *Commissioner* v. *Guminski*, 198 F. 2d 265 (C. A. 5th);

Jones v. *Herber,* 198 F. 2d 544 (C. A. 10th); *Roybark* v. *United States,* 218 F. 2d 165 (C. A. 9th). The term "gross income" should not be given a different meaning for purposes of Section 275 (c).

Clearly, understatements of gains from the sale of property, whether they result from understatements of gross receipts or overstatements of basis, are understatements of gross income, as defined in Section 22 (a). In the language of Section 275 (c), such understatements are omissions from gross income of amounts properly includible therein, and when—as in the case at bar—they exceed 25% of the gross income stated in the return, the five year period of limitation applies.

CONCLUSION

For the foregoing reasons, the judgment below is correct and should be affirmed.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
JOSEPH F. GOETTEN,
GRANT W. WIPRUD,
Attorneys.

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